Yardeni Research

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Morning Briefing

Fed's Blackout & Foreign Bond Buyers

Check out the accompanying chart collection.

Executive Summary: The Fed has cut the federal funds rate more than enough. Further cutting in December, which the financial markets expect, could send one side of the Fed's dual mandate in the wrong direction, since inflation remains sticky, while the labor market remains strong. Today, Eric examines the weak rationale for cutting further and the potential consequences doing so could hold. … Also: Why the 10-year Treasury bond yield is slightly lower than we expected.

Weekly Webcast. If you missed Monday's live webcast, you can view a replay *here*.

The Fed: Dual Dilemma. Last week's November employment report brought further proof that the summer slowdown in the labor market was a blip. We expect this week's November CPI data to show that inflation has been sticking too high above the Fed's 2.0% target. With both sides of the Fed's dual mandate (stable prices and full employment) heating up, it's increasingly likely that the Fed has cut the federal funds rate (FFR) by too much, too soon. We suspected as much when we raised the odds of a stock market meltup following the Fed's 50bps cut in September. The bond market did too, as long-term bonds sold off and yields surged (*Fig. 1*).

A week ago, Fed Governor Christopher Waller said he *doesn't regret* the September cut, which he chalked up to taking out insurance against softer employment and inflation data. He also equated himself to an MMA fighter who keeps getting inflation in a chokehold, only for it to slip away. But if the economy is stronger than the Fed thought and inflation hasn't been tamed, why should the Fed cut the FFR any further?

Fed Chair Jerome Powell and other Federal Open Market Committee (FOMC) members have pointed to the neutral FFR as their North Star. Despite the fact that the neutral rate that neither stimulates nor dampens the economy is unknowable and unobservable, the FOMC seems convinced that it is lower than the current 4.50%-4.75%.

Astronomy aside, the reasoning for a 25bps cut on December 18 might simply be because markets expect one. The *CME FedWatch tool* shows an 87% probability of a cut, and FFR futures show at least one more in the first half of 2025 (*Fig. 2*).

Unless a December cut is accompanied by a very hawkish press conference by Powell—which he has not delivered since becoming a dove at August's Jackson Hole speech—it could send the stock market melting up even higher. That would increase the likelihood of a stock market correction early next year and risk overheating the economy.

Our recommendation to the Fed is to stand pat at the December 17-18 FOMC meeting. The committee should take the time to see how the economy evolves in the coming months following Trump's win. Powell asserted at November's *FOMC meeting* that the Fed cannot (or will not) model the new administration's fiscal policy until it has been implemented. But while the effects of tax cuts and tariffs are uncertain, we do know that they are very likely to be at odds with easing monetary policy given that inflation is too high, real GDP growth is strong, and the labor market is near full employment. Alas, our warnings have gone unheeded since September, despite similar views shared by a few FOMC members.

Consider the possibilities for monetary policy as we head into 2025:

(1) *Nirvana rate.* The FOMC will release its updated quarterly *Summary of Economic Projections* (*SEP*) next week. It's likely that members' FFR projections will rise along with the increase in market expectations since the last release in September (*Fig. 3*). The dispersion of their views will remain wide, but the median projected path of policy is very likely to shift higher. Projections of the longer-run FFR are also likely to increase, which could see the median rise to 3.0%. We think the nominal neutral FFR is closer to 5%, while the FOMC's highest projection as of September is 3.8%. So monetary policy is likely to become increasingly stimulative as the Fed cuts toward this nirvana level that it believes will neither expand nor contract the economy.

(2) *Economic forecasts*. Changes in the Fed projections of GDP, the PCED inflation rate, and unemployment also provide a window into how the FOMC's views of the economy have shifted. Prevailing economic data suggest the median year-end projection for GDP will increase from 2.0% for the next two years (*Fig. 4*). Views of the PCED are likely to remain sanguine and show a gradual glide to 2.0% (*Fig. 5*). Unemployment projections are likely to be lowered, at least over the near term (*Fig. 6*).

The September SEP showed the Fed expected the FFR to end 2025 at 3.4%. Depending on the FOMC's updated view of how many cuts it foresees over the next year along with its macroeconomic outlook, we can parse potential policy reactions to economic surprises next year. For instance, if growth is stronger (weaker) or the PCED is higher (lower) than the FOMC expected, then the FFR is likely to be higher (lower) than the forecast.

(3) *Economic reacceleration*. Depending on Wednesday's CPI report for November, the Fed may be cutting the FFR in December to a full percentage point lower than where it was four months ago even though supercore CPI (services excluding shelter) stands above 4.5% y/y and nominal wage growth is 4.0% y/y (*Fig. 7* and *Fig. 8*).

Wage growth doesn't seem likely to slow, either. Small businesses' plans to raise workers' compensation over the next three months surged from 18% in July to 28% in November's NFIB small business survey (*Fig. 9*). This series is correlated with the employment cost index (ECI), the Fed's preferred gauge of labor costs. So it's likely that the ECI will get stuck at historically high levels rather than those consistent with 2.0% consumer inflation. That is also likely to keep supercore CPI elevated given the importance of labor costs to services excluding housing.

Meanwhile, the number of small businesses with job openings or planning to increase employment over the next three months also increased in November (*Fig. 10*). The labor market is not just resilient but reaccelerating under expectations for a lower corporate tax rate and deregulation under Trump 2.0.

(4) *Balance-sheet policy.* Minutes from the Fed's November meeting showed that the FOMC may consider a technical adjustment to the rate paid on the overnight reverse repurchase facility (ONRRP) soon. That could extend the runway for how long quantitative tightening (QT) could continue.

Recall, the RRP is the facility that swelled to more than $2 trillion in 2022 and 2023 as money-market funds flush with cash parked assets there to earn a rate that was at one point 5.30%. The ONRRP rate is currently set 5bps above the bottom of the FFR target range. It was raised in June 2021 to prevent short-term money market rates (like the FFR) from sometimes leaking below it. Now, quantitative tightening (QT) is putting some pressure on bank reserves and therefore adding stress to money markets.

We still think QT will end sometime in the second half of 2025, as the RRP has largely been drained and reserve balances will start to fall much quicker. That's of course barring any adverse effects of the debt ceiling being reinstated in January. The GOP sweep in November should allow for a smooth negotiation process, but we will write about the potential impacts of any debt limit debacle in the coming weeks.

(5) *Blackout period.* The FOMC is in a blackout period ahead of its December 17-18 meeting, meaning that it cannot provide guidance for no FFR cut if a hot CPI changes their minds. Powell would have to phone *The Wall Street Journal's* Nick Timiraos to put a front-page story out.

But considering Powell's apparent confidence that pivoting to dovishness in August was the right move, even a cautious FOMC may cut the FFR by 25bps and in public comments assure the markets that the Fed remains data dependent and is unlikely to cut rates further.

Will the Fed wake up to the economic realities or will the elusive neutral-rate fantasy continue to guide monetary policy? We shall see.

Bonds: Global Yield Hunters Buying in the US. The 10-year US Treasury yield has fallen from 4.46% a month ago to 4.17%. The drop has aligned with the decrease in the Citigroup Economic Surprise Index (CESI) (*Fig. 11*). However, we still think the 10-year yield is a bit too low considering our expectations for strong economic growth and sticky inflation.

Our current 10-year yield target range is between 4.25% and 4.75%. We are expecting the 10-year TIPS yield to stabilize around 2.00% based on solid economic growth, while the inflation premium ranges between 2.25% and 2.75%, based on inflation getting stuck slightly above the Fed's 2.0% target.

So why have yields recently dropped slightly below our forecasted range? In addition to the (temporary) weakness in the CESI, foreign buyers hunting for yield are likely putting downward pressure on long-term Treasury yields.

Consider the following:

(1) *Global yields.* Disinflation (and deflation) and slow GDP growth overseas are weighing on global bond yields. Few developed countries have 10-year debt yielding 3% or more (*Fig. 12*). British gilt yields are less than 15bps higher than Treasury yields yet are accompanied by far less stable political and fiscal outlooks. Chinese debt continues to yield less than 2.0% (*Fig. 13*). So foreigners have few options outside of the US for safe and relatively high-yielding bonds.

(2) *Treasury International Capital System (TICS).* Treasury data, known as TICS, shows that foreign purchases of Treasury notes and bonds are running at a three-month annualized rate of $608 billion through September (*Fig. 14*). There was another $475 billion (three-month annualized) in US corporate debt purchased over this period (*Fig. 15*).

(3) *China.* China is one of the few countries shedding Treasuries (*Fig. 16*). China's $1.3 trillion stockpile, as of 2013, is now down to $772 billion. However, the fall has been accompanied by a rise in Treasuries bought by Belgium, Luxembourg, and the UK, which are global financial centers where China can accumulate Treasuries without showing them in its official account. That said, China is also one of the countries stocking up on gold, so it may be funding those purchases by selling Treasuries. China's central bank expanded its gold reserves in November after a six-month pause in purchases, Bloomberg has reported. Gold represents roughly 5.9% of China's total foreign reserves, up significantly over the past few years but still a fraction of its holdings (*Fig. 17*).

Calendars

US: Tues: NFIB Small Business Optimism Index 94.6; Nonfarm Productivity & Unit Labor Costs 2.2%/1.9%.**Wed:** Headline & Core CPI 0.2%m/m/2.7%y/y & 0.3%m/m/3.3%y/y; Federal Budget -$325.0b; MBA Mortgage Applications; 10-Year Note Auction; Crude Oil Inventories & Gasoline Production; OPEC Monthly Report. (FXStreet estimates)

Global: Tues: Germany CPI -0.7%m/m/2.4%y/y; Italy Industrial Production 0.1%; Eurogroup Meeting; China Balance of Trade $95.5b; RBA Interest Rate Decision 4.35%. **Wed:** Canada BoC Interest Rate Decision 3.25%; Australia Unemployment & Participation Rates 4.2%/67.1%; Balz. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): During the December 6 week, forward earnings moved higher for all three of these indexes simultaneously for a third straight week. That hadn't happened since late July, as the SMidCaps' forward earnings were mostly stalled since then. LargeCap's forward earnings rose last week for a 10th week to a record high after falling for two straight weeks for the first time since December (when it fell for three straight weeks). LargeCap had snapped its 37-week streak of record-high forward earnings during the September 13 week, which was its lengthiest string of weekly record-high forward earnings in nearly 19 years (since the November 11 week of 2005, when it hit record highs for 42 straight weeks). MidCap's improved to 1.7% below its record high in early June 2022. SmallCap's edged up to 12.2% below its mid-June 2022 record. LargeCap's forward earnings has soared 21.0% from its 54-week low during the week of February 1, 2023; MidCap's is 7.0% above its 55-week low during the week of March 10, 2023; and SmallCap's is 1.6% above its 72-week low during the March 17, 2023 week. These three indexes' forward earnings downtrends since mid-2022 have been relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Their forward earnings momentum has improved from three-year lows just over a year ago, but LargeCap's has improved faster than the SMidCap's. Here are the latest consensus earnings growth rates for 2024 and 2025: LargeCap (10.1%, 12.9%), MidCap (-0.6, 13.5), and SmallCap (-12.6, 17.9).

S&P 500/400/600 Valuation (*link*): Valuations were mostly lower w/w for these three indexes during the December 6 week. LargeCap's forward P/E rose 0.2pt w/w to a 43-month high of 22.3. It's up 5.3pts from a seven-month low of 17.0 during the October 27, 2023 week and 7.1pts from its 30-month low of 15.1 at the end of September 2022, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E dropped 0.1pt w/w to 17.0 from a 40-month high of 17.1. It's up 4.7pts from a 12-month low of 12.3 at the end of October last year and compares to a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E fell 0.3pt to 16.8 from a 41-month high of 17.1. It's up 6.2pts from its 14-year low of 10.6 in September 2022 and compares to a record low of 10.2 in November 2009 during the Great Financial Crisis. That also compares to its record high of 26.7 in early June 2020 when forward earnings was depressed. The forward P/Es of the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's 24% discount to LargeCap's P/E compares to 22% a week earlier, which was the lowest since the March 9, 2023 week and up from a 25-year-high 29% discount during the July 5, 2024 week. It had been at a 19% discount during the March 2, 2023 week, which was near its best reading since October 14, 2021. SmallCap's 25% discount compares to 23% a week earlier, which was the lowest since the March 9, 2023 week and up from a 24-year-low 34% discount during the July 5, 2024 week. That compares to a 20% discount during the March 2, 2023 week; that one was near its lowest discount since August 2021. SmallCap's 1% discount to MidCap's is among the smallest since July 2021. Prior to that from 2003 to 2018, SmallCap's P/E had been mostly above Midcap's, and both were above LargeCap's.

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